

OFFICE OF THE
CITY AUDITOR

AN AUDIT OF THE DEFERRED COMPENSATION
PROGRAM

A REPORT TO THE
SAN JOSE
CITY COUNCIL

FEBRUARY 1986

TABLE OF CONTENTS

	<u>Page</u>
EXECUTIVE SUMMARY	i
BACKGROUND	1
SCOPE AND METHODOLOGY	2
IMPROVEMENTS ARE NEEDED IN THE ADMINISTRATION OF THE CITY'S DEFERRED COMPENSATION PLAN	4
CONCLUSION	12
RECOMMENDATIONS	12
MATTERS FOR CITY COUNCIL CONSIDERATION	13
PERSONNEL DEPARTMENT RESPONSE	15

EXECUTIVE SUMMARY

Our review of the Deferred Compensation Committee's administration of the City's Deferred Compensation Plan (Plan) revealed the following:

- o Some Plan participants deferred more income than the I.R.S. regulations allow
- o The Committee has not monitored the Plan investment companies to ensure that they comply with the terms of their agreements with the City

Specifically, we found that 90 Plan participants deferred more income in tax year 1984 than the I.R.S. regulations allow. Although most of these participants exceeded the limit by a small amount, one participant deferred \$2600 more than the regulations allow. The Personnel Department, which has responsibility for monitoring employee contributions has not developed and implemented written procedures to ensure that employees do not contribute more than the regulations allow.

In addition, the Plan investment companies have not complied with provisions of the agreements intended to protect the Plan's assets. Specifically, the companies have not provided proof to the City that they obtained required insurance coverage to protect the Plan from losses. As a result, the City has no assurance that the Plan's assets are adequately insured. In fact, one company did not provide insurance required by its agreement with the City for over three years after the agreement was signed.

The Deferred Compensation Advisory Committee which has overall responsibility for administering the Plan has not monitored the investment companies because formal responsibility to do so has not been assigned. As a result, no City Department or employee is performing this function.

Further, our review found that the Deferred Compensation Advisory Committee has not developed a written policy manual to guide the implementation of the Plan's objectives and to provide consistency in administration of the Plan.

Finally, our review found that the City Council may need to take action to resolve a conflict between the City Charter and a City Council Resolution. When the City Council established the Deferred Compensation Advisory Committee in

1975, it allowed the City Manager and employee organizations to appoint the members of the Committee. However, this resolution conflicts with the City Charter which requires the City Council to appoint all members of boards and commissions. Therefore, the City Council may need to take action to resolve this conflict.

To improve the administration of the Deferred Compensation Plan, it is recommended that:

Recommendation #1:

The Deferred Compensation Advisory Committee formally assign responsibility for monitoring the investment companies to ensure that they comply with the terms of their agreements. (Priority 2)

Recommendation #2:

The Deferred Compensation Advisory Committee develop a written policy manual to guide the implementation of the Plan's objectives and to provide consistency in the administration of the Plan. (Priority 2)

Recommendation #3:

The Personnel Department develop and implement written procedures to ensure that employee contributions do not exceed the I.R.S. limits. (Priority 2)

To ensure compliance with the City Charter it is recommended that:

Recommendation #4:

The City Council allow the employee organizations and the City Manager to nominate members to the Advisory Committee and that the City Council formally appoint these members.
(Priority 3)

BACKGROUND

The City established a Deferred Compensation Plan (Plan) in 1975, to attract and maintain personnel. The Plan allows all employees, officers, or elected officials to defer and invest up to the lesser of 33.3 percent of their includable wages*, or \$7,500 of their gross salaries and wages annually. The deferred income and the resultant investment earnings are excluded from taxable income until paid to the employee.

As of May, 1985, the Deferred Compensation Plan had over 1,100 participant accounts and over \$13 million in assets. A number of investment companies have been hired to maintain custody over and invest the Plan's assets. There are seven investment companies that hold Fund assets while only four of these companies are currently receiving contributions. These four companies hold over 99% of the Plan's assets.

*Includable wages are an employee's gross wages less the amount of income deferred.

The investment companies holding assets, the amounts they are holding, and the percentage of the Plan's assets that they hold are as follows:

<u>Active Plan Companies*</u>	<u>May 31, 1985</u>	<u>Percentage of the Plan's Total Assets</u>
Great Western (Money Stock Funds and Bond Fund)	\$ 6,663,000	50.2%
Aetna - Money Funds, Stock Fund and Bond Fund	5,488,000	41.3
National Investors Life (Only one current contributor)	1,075,000	8.1
ICMA Retirement (New Option)	<u>7,000</u>	<u>0.1</u>
	13,233,000	99.7
<u>Inactive Plan Companies*</u>		
Babson	22,000	0.2
Beneficial Standard	16,000	0.1
Pacific Fidelity	<u>3,000</u>	<u>-</u>
TOTAL GENERAL LEDGER VALUE	<u>\$13,274,000</u>	<u>100.0%</u>

Scope and Methodology

We reviewed the City's Deferred Compensation Plan to determine whether the Advisory Committee is effectively administering the Plan in accordance with Federal laws and

*Active Plan Companies are those companies currently accepting contributions and Inactive Plan Companies are those companies no longer accepting contributions.

regulations, the City Charter, City Policy, and the Municipal Code. In addition, we reviewed the Plan to assess whether the Plan's assets are being adequately protected from losses. The results of our audit work are presented in FINDING 1. We also assessed whether participants' deferred income was promptly transferred to the investment companies and recorded in an accurate and timely manner. Our review of this audit area revealed no significant exceptions.

In conducting this audit, we interviewed members of Deferred Compensation Advisory Committee, representatives from Great Western, and staff in the Finance Department and the Personnel Department. We also reviewed appropriate Federal laws and regulations, State laws, the City Charter, City Ordinances, City Council Resolutions, City records, investment company reports, and minutes of the Advisory Committee meetings. In addition, we tested participant deferrals, their remittance to investment companies, and their recording to individuals' accounts.

FINDING 1

IMPROVEMENTS ARE NEEDED

IN THE ADMINISTRATION OF

THE CITY'S DEFERRED COMPENSATION PLAN

Improvements are needed in the administration of the City's Deferred Compensation Plan (Plan). Specifically, our review identified the following:

- o Some Plan participants deferred more income than I.R.S. regulations allow because the Personnel Department has not developed and implemented written procedures to monitor employee contributions
- o No department is monitoring the investment companies to ensure that they comply with the terms of their agreements. This is caused by the Advisory Committee not formally assigning responsibility for this function

Advisory Committee's Responsibilities

The City Council, when it established the Deferred Compensation Plan, gave sole authority for administering the

Plan to the Deferred Compensation Advisory Committee. The Advisory Committee is comprised of five members, four of whom were selected by various employee representation groups and one selected by the City Manager.

Title 3, Chapter 3.48.060 of the San Jose Municipal Code states that the Advisory Committee shall have the following responsibilities:

"The plan shall be administered by an Advisory Committee which shall be the sole authority to enforce the Plan and shall be responsible for the operation of the Plan in accordance with its terms, and shall determine all the questions arising out of the administration, interpretation, and application of the Plan, including making decisions on behalf of the City as to the choice and nature of investments to be available under the Plan, which determinations shall be conclusive and binding on all persons. The Committee shall have the authority to enter into agreements on behalf of the City for the administration of the Plan, for custodial agreements for funds, and for investments under the Plan where the fees to be paid under such an agreement are to be paid by the participants or where there is no amount to be paid by the City under the Agreement."

City Department's such as Personnel and Finance assist the Advisory Committee in administering the Plan. For example, the Personnel Department enrolls members into the Deferred Compensation Plan and monitors employee contributions relative to I.R.S. contribution limits. The Finance Department provides accounting and risk management services for the Plan.

Our review found that improvements are needed in the administration of the City's Deferred Compensation Plan. Specifically, we found the following:

- o Some Plan participants deferred more income than the IRS regulations allow
- o The Advisory Committee is not monitoring the Plan investment companies to ensure that they comply with the terms of their agreements

Participants Deferred More Income
Than The I.R.S. Allows

Federal Regulations allow individuals to defer a portion of their income if they contribute to an "eligible deferred compensation plan". To be an "eligible plan", the Plan must be established and maintained in accordance with Federal Regulations. These regulations specify who can contribute to the plan, when funds can be withdrawn, and limits on the amount of income that can be deferred. For example, the limit on the amount of income that can be deferred in a tax year is the lesser of \$7,500 or 33.3 percent of an individual's includable income. If the Plan does not adhere to this or any other requirements, the Internal Revenue Service (I.R.S.) can declare that the plan is not an "eligible plan". If this were to occur, individuals could not defer taxable income under this plan.

Federal Regulations specify the process which the I.R.S. is to follow to declare that a plan is not an "eligible plan." The process is as follows:

1. The I.R.S. must notify the Plan in writing that it is not complying with the regulations
2. The Plan is then allowed a period of time, not less than 180 days, to correct the deficiency
3. If the deficiency is not corrected within the allotted timeframe, the Plan ceases to be an "eligible plan."

Our review found a limited number of exceptions to the I.R.S. regulations which restrict the amount of income that an individual can defer in one tax year. Specifically, for tax year 1984, we identified 90 participants that deferred more income than the I.R.S. regulations allow. Most of these participants exceeded the limit by a small amount. For example, 80 of them exceeded the limit by one dollar and 8 others exceeded the limit by less than \$75. However, we did find one participant that exceeded the limit by \$2,650 and another one that exceeded the limit by \$340. Thus, the City's

Deferred Compensation Plan is not fully complying with the requirements of an "eligible plan". Since the I.R.S. regulations allow for correcting any identified deficiencies, the City's Plan is probably not in any immediate danger of losing its "eligible plan" status. However, since the Federal Regulations require that the Plan be maintained in accordance with these regulations, the deficiencies that we identified should be corrected.

The Personnel Department has responsibility for monitoring employee contributions to ensure that the City complies with the I.R.S. regulations. According to the Retirement and Benefits Administrator, the Personnel Department is aware that some employees are contributing more than the I.R.S. regulations allow and is taking steps to correct the problem. Specifically, at the end of the year, the Personnel Department reviews payroll records to identify individuals that contributed more than the I.R.S. limit. If they identify someone who contributed more than the limit, the Personnel Department refunds the excess contribution. Our review identified several instances in which the Personnel Department refunded contributions in excess of the I.R.S. limit.

Although the Personnel Department has taken steps to correct this problem, more improvements are needed so that the Plan is in total compliance with the Federal Regulations. Specifically, the Personnel Department needs to develop and implement written procedures to monitor employee contributions.

Not Monitoring the Investment Companies

The Advisory Committee has not adequately monitored the Plan's investment companies to ensure that they comply with the terms of the agreement. As a result, the Plan investment companies have not complied with certain terms of their agreements that require them to provide insurance or collateral for the Plan's assets. Specifically, the agreement with Aetna, which was signed in 1982, requires Aetna to obtain a \$5 million errors and omissions policy to protect the Plan's assets from losses due to unintentional errors or omissions. However, Aetna has not provided any proof that it obtained the required coverage. Without this proof, the City has no assurance that the contractor has obtained the required insurance. It should be noted that the City normally requires contractors to submit proof that they have obtained required insurance.

In March 1985, an Aetna official verified that the required errors and omissions policy had not been obtained. While Aetna provided proof in April 1985, that it had obtained

a \$5 million fidelity bond, which protects against losses due to fraud, as of May 1985, the Plan was not protected against losses resulting from unintentional errors or omissions on Aetna's part. Accordingly, the Plan's assets were 1) not insured against losses due to errors or omissions on Aetna's part and 2) unnecessarily at risk to the extent losses of this type occur.

In November 1985, subsequent to our review, Aetna provided proof to the City that it obtained the required errors and omissions policy. Nevertheless, the City lacked proof that Plan assets were adequately insured for over three years.

Similarly, Great Western did not provide proof to the City that it maintained insurance coverage required by its agreement. Great Western's agreement requires it to maintain an errors and omissions policy, a general liability policy, and a fidelity bond. However, the proofs of insurance Great Western submitted to the City indicate that the policies expired in May 1984. Moreover, Great Western has not subsequently provided additional proof to the City that it has renewed these policies. Therefore, the City has no assurance that Plan assets are adequately insured and those assets may be unnecessarily at risk.

In addition, the City has not monitored Great Western to verify that Great Western has compiled with the agreement provision that requires them to provide collateral for savings account balances that exceed the limit the Federal Savings and Loan Insurance Corporation (FSLIC) will insure. The agreement requires Great Western to provide collateral valued at 125 percent of the amount in any individual's savings account that exceeds the FSLIC limit of \$100,000. As of December 1985, two participants account balances exceeded the \$100,000 limit and other participants should exceed this limit in the near future. However, no City official is responsible for verifying that Great Western has provided the required collateral. As a result, the City has no assurance that the collateral has been provided and amounts in the participant savings accounts that exceed the \$100,000 limit are unnecessarily at risk.

Because the Advisory Committee has not formally assigned monitoring responsibilities to any City Department or employee, this function is not being performed. In our opinion, the Committee should coordinate insurance coverages and collateral activities with the City's Risk Management Section to ensure that the proper insurance coverages are maintained in accordance with the agreements.

CONCLUSION

Our review found that improvements are needed in the administration of the City's Deferred Compensation Plan. Specifically, we found the following:

- o Some plan participants deferred more income than the I.R.S. regulations allow
- o The Advisory Committee has not formally assigned responsibility for monitoring the Plan's investment companies

RECOMMENDATIONS

To improve its administration of the Deferred Compensation Plan, it is recommended that:

Recommendation #1:

The Deferred Compensation Advisory Committee formally assign responsibility for monitoring the investment companies. (Priority 2)

Recommendation #2:

The Deferred Compensation Advisory Committee ensure that written policies and procedures are developed and implemented for all Plan activities. (Priority 2)

Recommendation #3:

The Personnel Department develop and implement written procedures to ensure that employee contributions do not exceed the I.R.S. limits. (Priority 2)

Matters for City Council Consideration

In addition, we noted that the City Charter conflicts with a City Council resolution regarding the appointment of members to the Deferred Compensation Advisory Committee. Article X, Section 1002 of the City Charter, requires the City Council to appoint all members of boards and commissions. However, the Advisory Committee members are selected in accordance with City Council Resolution #46536, dated March 1975, which allows the employee organizations and the City Manager to appoint the members.

We asked the City Attorney's Office to give us a legal opinion on whether the City Council should appoint the members of the Advisory Committee. In its opinion, the City Attorney's Office stated that the City Council should formally appoint the members.

Accordingly, it is recommended that:

Recommendation #4:

The City Council allow the employee organizations and the City Manager to nominate members to the Advisory Committee and that the City Council formally appoint these members.

(Priority 3)

CITY OF SAN JOSE—MEMORANDUM

TO Jerry Silva
Auditor
SUBJECT DEFERRED COMPENSATION PROGRAM AUDIT

FROM Edward F. Overton

DATE January 31, 1986

APPROVED

DATE

We have reviewed the draft report of the audit of the Deferred Compensation Program. As I am sure you are aware, the audit has taken a long time; and, your staff has put in many hours in completing its work. We appreciate your work. Our desire is to have the report reflect as accurately as possible the operational and financial condition of the Deferred Compensation Plan for the period coinciding with the end of the audit. If this is done, we can correct any problems which are identified.

The report identifies four issues that appear to need attention. They are:

1. Employee deferring more salary than the regulations allow
2. Inadequate monitoring of administrative contracts
3. Advisory Committee needs to develop written policy
4. Council appointment of committee members

These items have become issues because of the history of the implementation of the deferred compensation program. The City Council was originally sold the deferred compensation on the basis that the City would not have to make a major commitment of City resources to the program. The Deferred Compensation Advisory Committee was supposed to manage the program through its outside administrators. Therefore, no staff has ever been added to a city department to monitor deferred compensation activities. As you pointed out in your review of almost a year ago, the plan has over 1,100 participants and over \$13 million in assets. In addition, the rate of deferral exceeds \$4 million annually. When we started the program in 1975 we were dealing with one plan administrators. We now have seven companies who hold city funds, with four actively receiving contributions. With the complexity of the administrative process and the rapid growth of the plan's assets, we need to seriously consider adding at least one full time staff person to administer this program.

We are aware of the specific issues that you raised in your report. When we become aware of employee deferrals which exceed the limit, we make refunds to the employee. In addition, we are working with Finance and Information Systems on a set of controls to prevent over deferrals. Currently, we are monitoring the program manually. However, we anticipate that the automated reporting will be in place approximately March 1, 1986.

RECEIVED
FEB 4 1986

CITY AUDITOR

DEFERRED COMPENSATION PROGRAM AUDIT
Page 2

We have also found that while the plan administrators have been lax in providing evidence of their insurance coverage, they were in fact properly insured. Therefore, the plan assets were not at risk. We have taken steps to get the evidence of coverage for our files. We will also verify that the collateral requirements are being met.

I have already addressed the need for staff. It is the only way that the deferred compensation committee can function. They can only assign work with the approval of the City Manager.

Currently, the City Manager has placed the responsibility for administering the Deferred Compensation program with the Personnel Department. Therefore, any work of the committee is properly the responsibility of Personnel. We are currently working on written procedures and policies.

Finally, upon adoption of this report, the committee will forward a recommendation to the Council that they formally appoint the members of the Deferred Compensation Advisory Committee.

A handwritten signature in black ink, appearing to read "Edward F. Overton", with a stylized flourish at the end.

Edward F. Overton
Retirement & Benefits Administrator

8092P